

Internal Revenue Service
Director, Exempt Organizations

Department of the Treasury
TE/GF

Person to Contact:

Contact Telephone Number:

In Reply Refer to:

Date: NOV 3 2000

CERTIFIED MAIL

Dear Applicant:

We have considered your application for recognition of exemption under section 501(c)(3) of the Internal Revenue Code and have qualified for exemption under that section. Our reasons for this are explained below.

You were incorporated in [REDACTED] to operate a twenty four-hour residential childcare facility and child placement agency, and to do all other acts that are permitted by 501(c)(3) corporations.

Page 2 of Form 1023 states, "The purpose of [REDACTED] is to provide an opportunity for abused and delinquent boys to learn the social, emotional, and intellectual skills needed to function as a well-integrated and successful member of society. [REDACTED] seeks to assist vulnerable and at-risk families with child rearing and parenting skills by directly intervening with the individual boy and by working with the family system."

"As a means of accomplishing this purpose, [REDACTED] will provide a residential group home for boys who are referred from the [REDACTED]. The establishment and operation of this facility will occupy 100% of the time and resources of the organization. For those admitted, [REDACTED] will provide the following:

- ❖ Professional assessment of each child by a child psychiatrist, pediatrician and dentist
- ❖ Ongoing treatment in a structured environment with limits and boundaries
- ❖ Specific behavioral treatment designed for each child's needs
- ❖ Weekly support groups and behavioral group sessions
- ❖ Recreational services through daily planned activities
- ❖ Preparation for independent living by teaching independent living skills
- ❖ Assessment of family system of each child
- ❖ Family therapy sessions, as appropriate
- ❖ Support for family unification when possible
- ❖ Ongoing medical services
- ❖ Educational services through attendance at public schools
- ❖ Support for the public schools through interaction with teachers and staff
- ❖ Religious services as desired
- ❖ Group home with in-house staff
- ❖ Food, clothing and shelter

The facility will begin operations in [REDACTED] and is located at [REDACTED].

The Directors are [REDACTED], and [REDACTED]. Your letter dated [REDACTED] states the officers of the corporation are [REDACTED] and [REDACTED]; [REDACTED] states [REDACTED] and [REDACTED].

Page 3 of Form 1023 #5 states, "*The name of the corporation is the same as the name of a sole proprietorship operating in [REDACTED]. [REDACTED] is a director for both organizations.*"

Page 4 of Form 1230 #10a states, "[REDACTED] a Director and a property owner/lessor for the facility."

A copy of the lease agreement revealed the monthly rent of this corporation would be \$[REDACTED] a month. The property has a first and second mortgage, \$[REDACTED] a month and \$[REDACTED] a month respectively.

Income will be derived from government contracts and expended for salaries, rent, utilities, travel and operations.

Section 501(c)(3) of the Internal Revenue Code provides for exemption from Federal income tax for organizations which are organized and operated exclusively for charitable, religious, and educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order to qualify for exemption under section 501(c)(3), an organization must be both organized and operated exclusively for one or more exempt purposes. Failure to meet either the organizational or operational test will disqualify an organization from exemption under section 501(c)(3).

Section 1.501(c)(3)-1(c)(1) of the Regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish such purposes. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. Thus, in construing the meaning of the phrase "exclusively for educational purposes" in Better Business Bureau v. United States, 326 U.S. 279 (1945), the Supreme Court of the United States stated, "This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations states that an organization is not organized or operated for any purpose under section 501(c)(3), unless it serves a public rather than a private interest. Thus to meet the requirements of this subparagraph, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization or persons controlled, directly or indirectly, by such private interests. Moreover, even though an organization may have exempt purposes, it will not be considered as operating exclusively for such purposes, if more than an insubstantial part of its activities serve private interests.

In Bubbling Well Church of Universal Love v Commissioner, U.S. Court of Appeals 9th Circuit No. 80-7358 11-27-81 affirmed 74 TC 531, the tax court reviews an organization that states it is a church operating exclusively for religious purposes. The church was established by three members of one family, who also serve as the sole members of the Board of Trustees and/or directors. The organization had no affiliation with any denomination or ecclesiastical body and was not subject to any outside influence in the control of the organization's affairs.

The organization receives income of approximately \$61,000 during a one-year period. Of this amount approximately \$37,000 was directly returned to the family in the form of living allowance, parsonage allowance, medical expenses, medical insurance and travel expenses. This amounted to 61 percent of the organization's income that directly benefited the founding family.

The court stated that under the circumstances described, the family was in a position to perpetuate control of the organization's operations indefinitely, prepare its budget and had complete control of the organization's finances and made the decisions on how the funds were spent. Since the organization had no connection with any denomination or outside body, it was not subject to any outside influence in the conduct of the church's affairs.

Concerning the amount of compensation paid to family members, the court stated that the applicant organization has the burden of proving that the compensation paid its officers is reasonable and comparable to salaries paid for similar positions within a particular industry. In denying exemption to this organization, the court stated that the organization had not shown that no part of the net earnings did inure to the family members and that the organization was operated for the private benefit of the family rather than public purposes.

In Hancock Academy of Savannah, Inc. v Commissioner, 69 TC 488, the founder of a for-profit entity formed a non profit corporation to take over the educational functions of the for-profit. The non-profit assumed an excessive liability of the for-profit. The court found the academy failed to meet the requirements of section 501(c)(3).

In John Marshall Law School and John Marshall University v US, 81-2 USTC, an organization that operated a law school and university did not qualify as an exempt organization because a portion of the organization's net earnings inured to the benefit of the private individuals who operated the organization and their families. The corporation contended that the benefits inuring to the individuals were reasonable compensation for the services they performed, but the court concluded that the payment of personal expenses purchases and interest-free loans involved here far exceeded an ordinary and necessary level of compensation.

Revenue Ruling 76-91, published in Cumulative Bulletin 1976-1, on page 140, provides that where the purchaser is controlled by the seller or there is a close relationship between the two at the time of the transaction, the presumption is that the agreement cannot be made because the elements of an arm's length transaction are not present.

Revenue Ruling 76-441, Cumulative Bulletin, 1976-2, page 147 held that a nonprofit organization takes over a school's assets and its liabilities, which exceed the value of the assets and include notes owed to the former owners and current directors of the school, is serving the director's private interest and is not operated exclusively for educational and charitable purposes.

INUREMENT/PRIVATE BENEFIT

ISSUE 1:

The evidence submitted by your organization disclosed that [REDACTED] and [REDACTED] closely control it through their positions as directors, officers and property owners. [REDACTED] will operate as the "interim" Executive Director. The self-perpetuating Board of Directors, which consist of [REDACTED] and [REDACTED], will determine his compensation.

The compensation arrangement lacks the elements of an arm's length transaction since the agreements are set by the recipients rather than through an independent third party based on objective criteria. This arrangement is similar to the one discussed in the cited precedent where the court stated that this compensation arrangement permitted the net earnings to inure to the benefit of private individuals. The court also stated that in this type of situation, the organization served private rather than public interests as required by section 501(c)(3) of the Internal Revenue Code. Bubbling Well Church of Universal Love v Commissioner, Supra

ISSUE 2:

The operations of the corporation are conducted out of property owned by [REDACTED]. The lease agreement is between [REDACTED] and [REDACTED]. The total of the two- (2) mortgages is \$[REDACTED]. The rent has been inflated to \$[REDACTED], an increase of \$[REDACTED], thereby relieving the property owner of his financial responsibility.

The inurement proscription contained in Regulations 1.501(c)(3)-1(c)(1) states that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. Inurement is likely to arise where the financial benefit represents a transfer of the organization's financial resources to an individual solely by virtue of the individual relationship with the organization without regard to the accomplishment of exempt purposes.

Inurement of income is strictly forbidden under section 501(c)(3) without regard to the amount involved. This proscription applies to persons who because of their particular relationship with an organization have an opportunity to control or influence its activities. Such persons are considered "insiders" for purposes of determining whether there is inurement of income. Generally, an organization's officers, directors, founders, and their families are considered "insiders".

A federal court of appeals held that the term "inurement": "may include more than the term net profits as shown by the books of the organization or than the difference between the gross receipts and disbursements in dollars" and that "[p]rofits may inure to the benefit of shareholders in other ways than dividends. See Northwestern Municipal Ass'n v Commissioner.

Although the purported purpose of the organization could be within the purview of section 501(c)(3) of Code, we hold that the primary purpose is to benefit the directors and/or officers.

Based upon cited court cases, regulations and Code, we hold that your organization has excessive private benefit and inurement, thereby, defeating exemption.

Therefore, we have concluded that you do not qualify for exemption from Federal income tax as an organization described in section 501(c)(3) of the Code. In accordance with this determination, you are required to file Federal income tax returns on Form 1120.

Contributions to your organization are not deductible by donors under section 170(c)(2) of the Code.

If you do not agree with our determination, you may request consideration of this matter by the Office of Regional Director of Appeals. To do this, you should file a written appeal as explained in the enclosed Publication 892. Your appeal should give the facts, law, and any other information to support your position. If you want a hearing, please request it when you file your appeal and you will be contacted to arrange a date. The hearing may be held at the regional office, or, if you request, at any mutually convenient district office. If someone who is not one of your principal officers will represent you, that person will need to file a power of attorney or tax information authorization with us.

If you don't appeal this determination within 30 days from the date of this letter, as explained in Publication 892, this letter will become our final determination in this matter. Further, if you do not appeal this determination in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust administrative remedies. Section 7428(b)(2) of the Code provides, in part, that "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the district court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service."

Appeals submitted which do not contain all the documentation required by Publication 892 will be returned for completion.

If this letter becomes our final determination, the appropriate state officials of the State of Maryland will be notified in accordance with section 6104(c) of the Code.

If you have any questions, please contact the person whose name and telephone phone number are shown in the heading of this letter.

Sincerely,

Steven T. Miller

Steven T. Miller
Director, Exempt Organizations

Enclosure:
Publication 892
Notice 1214

cc: